AN INTERACTION BETWEEN FINANCIAL PRACTICES AND FIRM PERFORMANCE WITH MODERATING EFFECT OF AGENCY COST IN PAKISTANI CORPORATE SECTOR

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DEDICATION

This thesis work is dedicated to my parents and my family who have always loved me unconditionally and whose good examples have taught me to work hard for the things that I aspire to achieve. This thesis work is dedicated to my brother, Dr. Babar Zaheer Butt, who has been a constant source of support and encouragement during the challenges of my study and life. I would also like to dedicate this work to my siblings who have always loved and encouraged me.

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ABSTRACT

This study investigates the application of firms' financial practices and its impact on firms' performance in economic conditions of an emerging market of Pakistan. Firm's financial practices include capital structure decisions, dividend policy decisions, investment appraisal techniques, working capital policy, methods of measuring cost of capital and financial assessment using financial ratios. This study analyzes the primary data of both financial and non-financial firms listed at Karachi Stock Exchange (KSE) of Pakistan. Data from 141 firms were analyzed using descriptive and factor analyses along with linear and multiple regression techniques to investigate the relationships between financial practices and firms' performance. The magnitude and significance of the moderating effect of agency cost was examined using multiple regression analysis on the relationship between capital structure decisions and dividend policy decisions with firms' performance. The descriptive findings of the study demonstrate that financial practices are followed in Pakistani corporate sector and are considered very important for a firm's performance. Results show that capital structure decisions and dividend policy decisions have a significant positive impact on firms' performance. In a similar vein, investment appraisal techniques, working capital policy, methods of measuring cost of capital and performance assessment using financial ratios are found to be significantly related to firms' performance. Furthermore, agency cost does not only exert a significant impact on firms' performance, but also moderates the relationship between dividend policy decisions and firms' performance. However, agency cost does not moderate the relationship between capital structure decisions and firms' performance. The study has both theoretical and practical implications for managers and practitioners about the magnitude of each financial practice in relation to agency costs and their contribution in the firms' performance.

ABSTRAK

Kajian ini mengkaji aplikasi amalan kewangan dan kesannya terhadap prestasi firma dalam keadaan ekonomi bagi pasaran baru di Pakistan. Amalan kewangan firma merangkumi keputusan struktur modal, keputusan polisi dividen, teknik penilaian pelaburan, polisi modal kerja, kaedah mengukur kos modal dan penilaian kewangan menggunakan nisbah kewangan. Kajian ini menganalisis data utama firma kewangan dan bukan kewangan yang disenaraikan di Bursa Saham Karachi (KSE), Pakistan. Data daripada 141 buah firma telah dianalisis menggunakan analisis deskriptif dan analisis faktor melalui teknik regresi linear dan regresi pelbagai untuk mengesan hubungan antara amalan kewangan dan prestasi firma. Magnitud dan kepentingan kesan penyederhana (moderator) iaitu kos agensi telah diperiksa dengan menggunakan analisis regresi berganda terhadap hubungan antara keputusan struktur modal dan keputusan polisi dividen dengan prestasi firma. Hasil kajian deskriptif menunjukkan bahawa amalan kewangan dipatuhi dalam sektor korporat di Pakistan serta mempengaruhi prestasi firma. Keputusan kajian juga menunjukkan bahawa keputusan struktur modal dan keputusan polisi dividen mempunyai kesan positif yang signifikan ke atas prestasi firma. Teknik penilaian pelaburan, polisi modal kerja, kaedah mengukur kos modal dan penilaian prestasi yang menggunakan nisbah kewangan didapati mempunyai hubungan signifikan terhadap prestasi firma. Seterusnya, kos agensi bukan sahaja memberikan kesan yang besar kepada prestasi firma, tetapi juga menyederhanakan hubungan antara keputusan polisi dividen dan prestasi firma. Namun, kos agensi tidak menyederhanakan hubungan antara keputusan struktur modal dan prestasi firma. Kajian ini mempunyai implikasi teori dan praktikal bagi pengurus dan pengamal mengenai magnitud setiap amalan kewangan berhubung dengan kos agensi dan sumbangannya terhadap prestasi firma.

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LIST OF ABBREVIATIONS

AC	-	Agency Cost
ARR	-	Accounting Rate of Return
ASF	-	Alternative Sources of Financing
CAPM	-	Capital Asset Pricing Model
MMCOC	-	Methods of Measuring Cost of Capital
CCI	-	Constraint on Capital Investment
CPAP	-	Contribution of Project to Aspect of Performance
CR	-	Cash ratio
CSD	-	Capital Structure Decisions
CSE	-	Common Stock Equity
CSR	-	Capital Structure Ratio
DCF	-	Discounted Cash Flow
DDM	-	Dividend Discount Model
D/E	-	Debt per Equity Ratio
DEVA	-	Discounted Economic Value Added
DIS	-	Dividend as a Source of Information
DPD	-	Dividend Policy Decisions
DPS	-	Dividend per Share
EPS	-	Earnings per Share
FAR	-	Financial Assessment through Financial Ratios
FCF	-	Free Cash Flow
GPR	-	Gross Profit Ratio
IAT	-	Investment Appraisal Techniques

ICR	-	Interest Coverage Ratio
IRR	-	Internal Rate of Return
IST	-	Investment Selection Techniques
KSE	-	Karachi Stock Exchange
LTD	-	Long-term Debt
NPR	-	Net Profit Ratio
NPT	-	Net Present Value
OP	-	Organization's Performance
OPR	-	Operating Profit Ratio
PBP	-	Pay Back Period
PDCC	-	Project Dependent Cost of Capital
P/E	-	Price per Earnings Ratio
PER	-	Performance
PI	-	Profitability Index
PMA	-	Profit margin/total Assets
PSE	-	Preferred Stock Equity
RI	-	Residual Income
ROA	-	Return on Assets
ROCE	-	Return on Capital Employed
ROE	-	Return on Equity
ROI	-	Return on Investment
RR	-	Rate of Return
RRR	-	Required Rate of Return
STA	-	Sales/total Assets
STD	-	Short-term Debt
TIE	-	Times interest earned ratio
TPR	-	Target Payout Ratio
WACC	-	Weighted average Cost of Capital
WCP	-	Working Capital Policy

LIST OF SYMBOLS

Ai	-	Independent but Controllable Variable
BBj	-	Independent but Uncontrollable Variable
F	-	Shows the Relationship between Dependent and Independent Variable (functional relationship) Variables Ai and BBj
OI	-	Dependent Variable
$\beta 0$	-	Symbolize or Abbreviated as Constant or Intercept
β	-	Beta Value or Slope of Regression Equation
ε	-	Error Term (Standard Error)

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CHAPTER 1

INTRODUCTION

1.1 Introduction

Financial infrastructure is always considered as the backbone of an economy. Current economic environment of a country demands a well-functioning financial system for economic growth and development. Corporate sector and well-functioning financial practices play a vital role in the economic growth and development of a country (Hunjra *et al.,* 2011). Financial strategies and investment moves are the key approaches for the performance of any company (McConnel & Servaes, 1990). The aim of this research study is to examine theoretically and empirically the application of financial practices and their impact on firm's performance as well as the moderating effect of agency cost. Therefore, this chapter begins with theoretical and empirical role of finance in decision-making (financial practices decisions) process and explains the relationship between financial practices and firm's performance. Thereafter, this study proceeds to identify the problem, which directs to the research objectives, research questions, and importance of the study. Hence, later on, in this chapter, scope, limitations, and outline of the study are presented.

1.2 Background of the Study

In current business conditions, rapid changes, innovations, technology and globalization are direct to make more competition among firms. Consequently, in this competitive business environment, profit, growth and survival of a firm depend upon the innovativeness of the firm (Kannadhasan and Nandagopal, 2008). Thus, firm can compete with market dynamic conditions only if it has strong financial position and flexible firm structure (Mathews, 2005). Rational analysts are always considered markets' efficiency while think about the investing and financing decisions. It believes that markets are always efficient, which raises two questions here, what will happen if markets are not always efficient? In addition, what will happen if analysts are not themselves always rational (Baker & Wurgler, 2012)? Decision related to anything cannot be made in vacuum since decision-making is very complicated activity. A firm cannot rely only on the complex models and individual resources, which are not able to provide a good result of investment in projects (Kannadhasan, 2008). Cognitive psychology of a manager is important in the analysis of the problem and variables including problems. While solving the problem, situation of decision-making activity in solving the individual specific problem is involved, which enlarges the environment as well (Barberis & Shleifer, 2003).

Process of choosing a specific alternative from a number of alternatives in consideration of their proper evaluation process is called decision-making (Scholleova, Fotr & Svecova, 2010). Therefore, managers should update themselves in multidimensional meadows, if they want to accomplish their desired goals or results in the competitive environments of businesses (Slovic, 1972). It is also necessary to understand the human nature (better insight of human in existing global perception, development skills and ability to generate best from investments) for the achievement of desired future goals of a firm. Moreover, for investors, it is vital to develop drive, foresight, preference and positive vision (Tversky & Kahneman, 1974). Various demographic factors (e.g. socio-economic background, age, education level, sex and race) differentiate one investor from another in many aspects and investment decision becomes a challenge for them (Kahneman & Tversky, 1979). In investment decision, investors should keep in mind their risk tolerance level, financial goals and other constraints. In addition, an optimum decision of investment can play a significant and active role in their choices (Archer & Ghasemzadeh, 1999; Combe, 1999; Bridges, 1999; Sommer, 1999; Cooper *et al.,* 2000). Optimum investment process is valuable for intuitional investors and not suitable for individual investor who is vulnerable to behavioral prejudices. In the past, investment decisions were based on forecasting, market timing and performance, because the major aim of an investment is to make wealth. In addition, investors were not fully satisfied and made little profit from investment due to ordinary outcomes of investment (Kıyılar & Acar, 2009). The existing gap between desired results and actual results forced them to investigate and find out the reasons behind these outcomes. In the investigation process, it is found that fundamental mistakes (irrational investment decisions) in decision-making process are behind these results. It is realized that the behaviour of decision-makers is important for avoiding such mistakes, which can create a barrier in better investment decisions (Kannadhasan, 2008). However, in order to explain the various investor behaviors in financial markets, it is necessary to understand the corporate culture, financial practices and their impact on performance.

Corporate sector has a significant role in the economy of any country because it is responsible for the decisions regarding production of services and goods that enhance the capacity of production as well as the profit (Hunjra *et al.,* 2011). In addition, finance strategies and investment moves are the key factors in the performance of any corporation. Therefore, proper management of financing and investment activities are more important in enhancing the return of shareholders (McConnel & Servaes, 1990). Application of financial practices and their role in the development of corporate sector has been discussed in financial literature, and most of these studies focus on the developed countries. McCaffery *et al.* (1997) reviewed the application of these practices in the UK retailing sector. Hunjra *et al.* (2011) worked on the financial practices and provided a descriptive analysis in corporate sector of Pakistan. Cowton & Pilz (1995) focused on retailing sector and employed investment appraisal techniques, while Morgan & Tang (1992) concentrated on distribution and financial services. Financial practices are discussed and analyzed separately (by including one or two practice only) by researchers, but collectively, only few researchers have examined these practices. In addition, there is a need of comprehensive analysis to determine the perception about practices and level of implications in corporate sector. Since financial managers, financial executives and financial analysts believe that these practices are very important for the improvement of firm performance, if appropriately practiced, which can also play a critical role in the development of firms (Hunjra *et al.,* 2011). In addition, it is necessary to explain the role of financial practices for the betterment of firm performance (Morgan & Tang, 1992; Cowton & Pilz, 1995; Hunjra *et al.,* 2011).

1.3 Financial Practices

1.3.1 Capital Structure Decisions

Capital structure of a firm consists of debt and equity proportions and it can be referred to financial framework of a firm. In addition, it has always been popular among scholars of financial studies (Myers, 1984; Heng & San, 2011). One can drive the significance of capital structure from the fact that basic purpose of capital structure is to fulfill the needs of various stakeholders. Therefore, development of new theories on optimal capital structure started from the last century and economic world was surprised when Modigliani and Miller (1958) came up with their irrelevance theorem of capital structure. They claim that under certain circumstances, the value of the firm is independent of its financial structure. However, institutional environment and firm's characteristics are the major determinants in the selection of optimal structure (Allayannis *et al.,* 2002; Marques & Santos, 2003; Grundströmer & Gustafsson, 2007; Antoniou *et al.,* 2008; Pratheepkanth, 2011). Capital structure occupies the decisions regarding different sources of funding[1], which are useful to

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[1] Sources of fund includes preferred stock and common stock called equity financing while long term debt finance, short term debt finance called debt financing

enhance the performance and firm needs for various sources of fund to finance its investments as well as business operations (Saeedi & Mahmoodi, 2011). Therefore, decisions about capital structure (debt/equity) are significant for value, growth and better performance of a firm (Antoniou *et al.,* 2008; Akintoye, 2008; Arbabiyan & Safari, 2009; Frank & Goyal, 2009; Al-Taleb & Al-Shubiri, 2011).

1.3.2 Dividend Policy Decisions

Dividend policy is related to proper distribution of firm's profit into shareholders (Marfo-Yiadom & Agyei, 2011). Since the controversy of capital structure, Miller & Modigliani (1961) initiated the importance of dividend policy or payout decisions. They established the fact that without market imperfections (e.g. transactions costs and taxes); dividend policy has no impact on firm's performance. In addition, Black (1976) appropriately referred this argument as "dividend puzzle" and the argument of irrelevance becomes more popular in the debates among researchers. Therefore, firms have to decide the proportions of earnings, how much to pay shareholders and how much to retain for further investment from the profit of a firm (Marfo-Yiadom & Agyei, 2011). Consequently, there are some factors in the business environment, which gradually become antecedents of dividend policy (Adefila *et al.,* 2004). These factors (determinants) include previous dividend, profitability, dividend signaling, current year earnings, firm size, ownership structure, age, risk, dividend changes and firm growth (Baker *et al.,* 2007; Archbold & Vieira, 2008; Jeong, 2008; Fodio, 2009; Hunjra *et al.,* 2011; Khan *et al.,* 2011). Managers use dividends as a source of information signaling related to future growth, earnings and performance of firm (Redding, 1997; Lazo, 1999). Generally, dividend policy decisions are considered very important for firm growth and have significant impact on performance (Amidu, 2007; Foong, Zakaria & Tan, 2007; Azhagaiah & Sabari, 2008; Al-Najjar & Hussainey, 2009a; Drnevich, 2011; Geng & Liu, 2011; Marfo-Yiadom & Agyei, 2011).

1.3.3 Investment Appraisal Techniques

Investment appraisal techniques are generally most surveyed topics in corporate finance, in the terms of financial practices (see, e.g. Sangster, 1993; Mccaffarey *et al.,* 1997). The fundamental purpose of investment appraisal techniques is to determine the long-term investment decisions (e.g. new machinery, replacement of machinery, research development projects, new plant, and new product) of a firm are worth hunting. Therefore, it would not be wrong to say that these techniques determine the budget for capital investments or capital expenditures (Seteven, 2003). In area of financial practices, investment appraisal techniques are very important although these techniques have some issues related to forecasting (Akalu, 2001; Hunjra *et al.,* 2012). However, from fundamentals of investment techniques, risk analysis is one of them (Akalu, 2001). In investment appraisal techniques, mostly used and accepted techniques include basic techniques[2] and discounted cash flow techniques[3], which are based on time value of money (Farragher, Kleiman & Sahu, 1999; Liljeblom & Vaihekoski, 2004; Kantudu, 2007; Akinbuli, 2011). Although, for selection of techniques, firms should follow a proper selection procedure, as Farragher *et al.* (1999) explained that for the effective and successful capital expenditure, it is necessary to make some plans. While selecting a suitable technique for investment appraisal, one should keep in mind these plans (e.g. strategic analysis, investment goals, investment opportunities, forecasting cash flow, evaluating the risks) (Akalu, 2002; Milis *et al.,* 2009; Afonso & Cunha, 2009). Therefore, vigorous investment appraisal techniques are very important for firm because these help the managers in ranking and selecting the best-suited projects. These techniques are very significant for a firm's growth, value and performance (Arnold, 1998; Drury, 2000; Olawale *et al.,* 2010; Halttunen, 2012).

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[2] Payback Period (PB) and Accounting Rate of Return (ARR) are the basic investment appraisal techniques.
[3] Internal Rate of Return (IRR), Net Present Value (NPV) and Profitability Index (PI) are the discounted cash flow techniques.

1.3.4 Working Capital Policy

The debates on capital structure decisions and dividend policy as well as investment appraisal techniques are related to long-term decisions of a firm (Mccaffarey *et al.,* 1997; Hunjra *et al.,* 2011), while working capital policy deals in management of operations of firm (mature within one year), liabilities and assets (Mccaffrey *et al.,* 1997; Hayajneh & Yaseeni, 2011). Therefore, almost every firm follows two types of working capital policies, aggressive policy and conservative policy. In aggressive working capital policy, firms take high risk for high profit by investing fewer amounts in current assets (Weinraub & Visscher, 1998 and Gardner *et al.,* 1986). This policy includes high risk because of the creditor who might claim for money and due to some reasons, firms are unable to settle creditor's claim, so it might create trouble for firms (Weinraub & Visscher, 1998; Nazir & Afza, 2009). For avoiding such kinds of dilemmas, it would be better for business to adopt conservative working capital policy. The advantage of this policy is that firm keeps a balance between current assets and current liabilities, and keeps protection to overcome any uncertain condition (Pinches, 1994). This policy can be very useful for firm in reducing risk but it decreases the opportunity of increasing production by decreasing available amount for firm (Teruel & Solano, 2007; Gill *et al.,* 2010; Niazi *et al.,* 2011; Qazi *et al.,* 2011). Many researchers (e.g. Afza & Nazir, 2007; Nazir & Afza, 2009; AL- Shubiri, 2011) have documented that working capital policy has strong impact on performance of a firm. The significance of working capital policy can be analyzed through the fact that it has strong effect on firm profitability. In addition, such risk affects the value and growth of a firm but working capital policy reduces that risk and enhances the performance (Smith, 1980).

1.3.5 Methods of Measuring Cost of Capital

In financial practices, methods of measuring cost of capital (MMCOC) are also very important for firms (Graham & Harvey, 2001). The definition of cost of capital is that it is a required rate of return by firm in order to meet the expense of generating finance in the markets (Al-Mutairi, 2011). In financial practices, investment decision making is very critical task (Kester *et al.,* 1999). Investing in a new project needs capital and this capital might bring some costs. It is difficult to find out that source of finance has cost or not, because every source of finance may or may not impose some cost on company (Rajatanavin & Venkatesh, 2007). Therefore, in these managerial decisions-making fields, some methods are used to calculate the cost of capital (Benetti, Decourt & Terra, 2007; Chazi, Terra & Zanella, 2010). These methods include weighted average cost of capital (WACC), capital asset pricing model (CAPM) and dividend discount model (DDM). In these methods, CAPM is a popular method in firms for calculating cost of capital (Kester *et al.,* 1999; Graham & Harvey, 2001; Brounen, De Jong & Koedijk, 2004). However, in corporate finance decisions, impact of methods of measuring cost of capital on firm's performance is very important because it is hard to estimate the accurate cost of any source of financing. Consequently, it is certain that high cost of capital has negative impact on performance of a firm (Bacidore *et al.,* 1997; Firer *et al.,* 2004; Vázquez & Trombetta, 2007; Rehman & Zaman, 2011).

1.3.6 Financial Assessment using Financial Ratios

Financial assessment of a firm is very vital in financial practices; hence, financial assessment ratios are used as instruments to determine whether firm's plans make financial sense (Horta et al., 2012). Therefore, evaluation of a business accurately plays a key role in the success of a firm. In the strong competitive environment of 21st century, it is significant for a firm to have considerable financial and non-financial structure[4]. In the old times (before 21st century), financial statements (income statements and balance sheets) were managed manually on annual basis and were used for assessing the performance of a firm (Mccaffarey *et al.,* 1997). The assessment of performance is planned and survival of a firm in long run depends upon the performance. Therefore, for measuring the overall prosperity

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[4] Financial and non-financial organization's structure includes efficient management, rapid response, high quality services and products.

of a firm, managers use performance assessment (Brigham & Ehrhard, 2005). Generally, financial performance is related to the revenue of a firm that how to generate profit by utilizing assets efficiently and effectively (Bashir, 2003). The term performance assessment provides the overall financial health of a firm and can be used in the comparison of similar firms across the same industry (Kaplan & Norton, 1996). However, performance can be defined in the form of growth, value, profit, output, productivity, brand image, sales etc (Almazari, 2011). Over the years, many tools and techniques have been developed for analyzing and judging the financial performance of a company (Palepu *et al.,* 2000). One of the most popular tool to evaluate these aspects is financial ratios assessment. Prior researchers (e.g., McCaffery *et al.,* 1997; Jahangir, Shill & Haque, 2007; Prasetyantoko & Parmono, 2008; Marimuthu, 2010; Ong, Teo & The, 2011; Memon & Tahir, 2012), evaluated the performance by using financial ratios persistently. These ratios include Price per Earnings ratio (PE), Return on Assets (ROA), Sales/Total Assets (STA), Cash Ratio (CR), Earnings Per Share (EPS), Return on Equity (ROE), Times Interest Earned ratio (TIE), Profit Margin/Total Assets (PMA), and Debt per Equity Ratio (D/E). Moreover, financial assessment by using financial ratios has shown strong positive impact on firm performance (Sufian, 2007; Niazi *et al.,* 2011; Ong *et al.,* 2011; Singh, 2011).

1.3.7 Agency Cost

Economic concept of agency cost is defined as, the cost of hiring or selecting an agent (manager, management etc) by principal (firm, person, group of persons, etc) to work on its behalf (Jensen, Solberg & Zorn, 1992; Hall, 1998). This cost arises due to the conflict of interest between principal and agent because agent has more knowledge about the firm and market conditions. Therefore, it is hard for principal to measure the activities of agent[5] (Myers, 2000). There are mostly two types of agency costs in business environment, agency cost of capital structure (debt/equity) and agency cost of dividend policy (free cash flow). Agency cost of

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[5] Such activities, which are not in the interest of principal but in the interest of agent.

capital structure arises due to the conflict of interest between shareholder and management. Shareholders will have to bear this cost as long as the interest of management differs from shareholders (Brigham & Gapenski, 1993). On the other hand, the agency cost of debt occurs due to the conflict of interest between debt holders and shareholders (Khan *et al.,* 2012). The debt-holders put some restrictions on firm while providing a debt because they want to secure their interest in the firm. They feel a threat from the management and shareholders. Similarly, interest of management and shareholders is against the debt-holders because management can transfer money to shareholders in many ways and leave the debt-holder without interest. Easterbrook (1984) and Jensen (1986) presented the agency cost of free cash flow and they argued that free cash flow available in firms is also responsible for agency cost (Yermack, 2006; Zhang, 2009). After paying all the obligation of firm, management can utilize the free cash for its own interest instead of distributing it to shareholders, and this action of management is against the interest of shareholders (Jensen, 1986). In this situation, dividend payment plays a positive role in reducing the agency cost; higher dividend payment reduces the available free cash flow to management and expects to reduce the agency cost (Rozeff, 1982; Lozano *et al.,* 2005). Moreover, higher payments of dividend are also an indicator of better future performance, growth and profit of firm (Litzenberger & Lang, 1989; Utami & Inanga, 2011). Therefore, many researchers documented the impact of agency costs on capital structure decision, dividend policy as well as on firm's performance (Lasfer, 1999; Jong & Dijk, 2002; Byrd, 2010; Stephan *et al.,* 2011; Bell, 2012).

1.4 Stock Markets in Pakistan

The economy of Pakistan is the 26th largest economy in the world in terms of purchasing power parity (PPP), and 44th largest economy in terms of nominal Gross Domestic Product (GDP), even though the country is sixth most populous country in the world. As Pakistan has a population of over 186 millions (the world's 6th-largest), thus GDP per capita is $3,149 ranking 140th in the world. Pakistan is a developing country and is one of the next eleven, the eleven countries that have a potential to become one of the world's large economies in the 21st century (KSE Articles, 2015).

In contemporary market dominated economic system, stock market performs a key role by mobilizing the financial means from savers to the potential investors (Mala and White, 2006; Shahbaz *et al*., 2008). An active equity market plays an important role in forecasting the economic growth of a country and is treated as a barometer of the economy (Singh, 2011). It exhibits the capital growth, saving and investor's faith in financial sector. Capital market being the most prominent component of financial system drives the financial strength through effective resource mobilization and consequently influences the economic growth and development of a country (Buyuksalvarci, 2010).

Pakistan comprehended the worth of equity market by setting up Karachi Stock Exchange (KSE) in 1949. In Pakistan, equity market principally reflects three stock markets, which are: (i) Islamabad Stock Exchange 10-Index, (ii) Karachi Stock Exchange 100-Index, (iii) Lahore Stock Exchange 25-Index. KSE is the largest and oldest of three exchanges in Pakistan since its inception (Nishat and Shaheen, 2004; Uppal and Mangla, 2006). At the start, KSE was measured by KSE-50 Index and there were seven companies listed on KSE with paid-up capital of Rs. 37 Million (KSE Articles, 2015). KSE is the most prominent equity market in Pakistan as it reflects almost 85% of the total turnover in the country (Javed, 2008). Initially, stock market in Pakistan was regulated by Corporate Law Authority (KSE, 2011). Asian Development Bank (ADB) introduced a plan in 1997, which involved the improvements of existing Corporate Law Authority. Hence, parliament approved and formally proclaimed the Act of Security and Exchange Commission of Pakistan (SECP) in December 1997 and consequently SECP replaced the Corporate Law Authority and started functioning from January, 1999, onward. In Pakistan, equity market improved significantly after the commencement of KSE as it emerged as a most important institution of capital formation in Pakistan and is voted as the most strongly performing market in Asia (Javed, 2008; ADB Report, 2008).

During the last decade, improvements in regulatory framework have motivated the local as well as foreign investors to make investments and the stock market has achieved exceptional performance (IMF Country Report, 2010). On December 31, 2014, 557 companies were listed on KSE, with average market capitalization of Rs.7380531 million (US$72287.3 million) (Economic Survey, 2013-2014). The companies listed at KSE have been classified into 34 sectors, representing almost all sectors of Pakistan's economy. Authorities have taken number of steps to improve the operations of capital market for enhancing the progression and solidity of financial sector and capital market in Pakistan (Javed, 2008). These steps included, implementing the code of corporate governance, establishing code of conduct for brokers, controlling through circuit breakers, electronic entry book system, no restriction on transfer of dividend and capital gain, no prior approval for issuance and transfer of shares to the foreigners, and setting up a National Clearing Company to promote clearing and settlement activities (Osei, 1998; Javed, 2008; IMF Country Report, 2010). These improvements generated returns and contributed to the economic growth through strengthening the economic and financial forces (Hondroyiannis *et al.,* 2005; Nieuwerburgh *et al.*, 2006).

Table 1.1: List of Companies with Market Capitalization

Years	**2010**	**2011**	**2012**	**2013**	**2014**
Listed Companies	644	638	573	560	557
Listed Capital (Rs in million)	919.26	1,048.87	1,094.40	1,129.82	1,168.89
Market Capitalization (million)	3,268.95	2,945.71	4,242.4	6,056.50	7,380.74
New Companies Listed	6	4	4	3	6
Listed Capital (in million)	33,438.45	16,010.82	8,161.04	4,545.07	26,973.48

Source: Karachi Stock Exchange (www.kse.com.pk, 2015)

In Pakistan, stock market has shown exceptional performance from 2005-06 to 2007-08 but has started to decline from mid of 2008 onward due to global financial crisis coupled with the decline in domestic economic indicators (IMF Country Report, 2010). Figure 1.1 shows rise in KSE-100 index from 2005-06 to 2007-2008; however, from the mid 2008 onward, as the global financial crisis starts affecting Pakistan, downward trend in KSE-100 index is observed. As at the end of March 2008, the aggregate market capitalization on KSE stood at $56 billion, which dropped to just $20 billion on January 2009, showing a significant decrease of $36 billion (Economic Survey, 2008-09). However, over the last four years (2011 to 2014) improvement in the performance (increase in market capitalization and profitability) of banking, oil and gas, chemical and personal goods attracted the foreign investors; which consequently has improved the KSE-100 index (Economic Survey, 2013-2014).

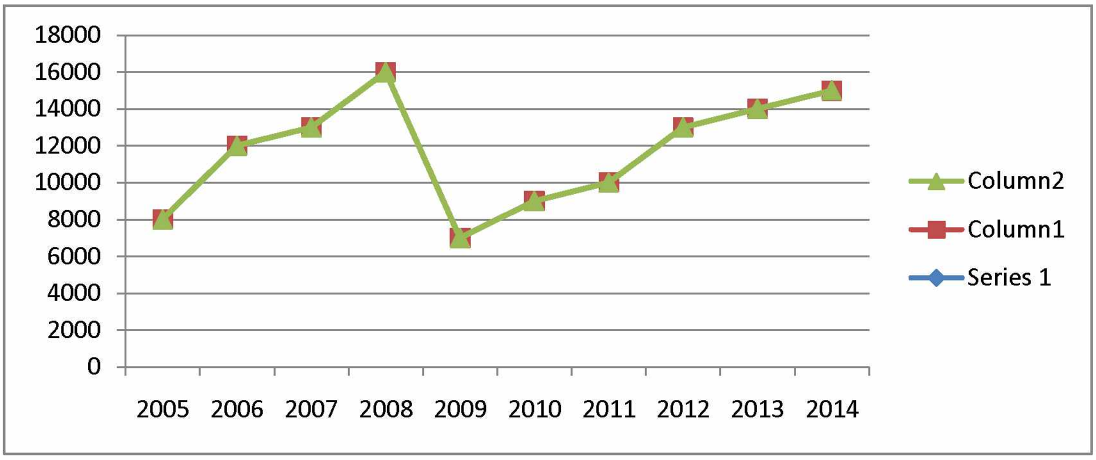

Figure 1.1 KSE 100 Index (2015). Source: www.kse.com.pk

It is clear from the debate on financial practices that the role of finance is very vital for managers, investors and financial analysts in decision-making process. It helps the managers in selecting and implementing financial practices properly. However, financial practices have strong impact on firm's performance but these practices are mostly followed in developed countries because market conditions of developed countries are much better than those of developing countries. Markets are perfect and working properly in developed countries, but in developing countries, scenario is different. Particularly to Pakistan, being a 26th largets economy in the world and having one of the excellent stock exchanges in the world, still the economic situation is not satisfactory. It is vital to determine the association between financial practices and the performance of various industries on stock market. This study is useful to develop an improved and effective economic policy for the growth and development of the economy.

1.5 Problem Statement

Corporate sector has a vital role in the growth and development of economy. It is clear from the literature that financial practices are very important, and management should concentrate on the proper utilization of these practices in decision-making (Pinegar & Wilbricht, 1989). Past studies on financial practices (e.g. McCaffery *et al.,* 1997; Graham & Harvey, 2001; Brounen *et al.,* 2004; Rajatanavin & Venkatesh, 2007; Al-Mutairi & Hasan, 2011; Hunjra *et al.,* 2011) are evident that these practices are reviewed in different sets of clauses. McCaffery *et al.* (1997) reviewed capital structure decision, dividend policy decision, investment appraisal techniques, working capital policy, and financial assessment using financial ratios. Graham & Harvey (2001) examined investment appraisal techniques, cost of capital, and capital structure decision. Al-Mutairi & Hasan (2011) investigated investment appraisal techniques, cost of capital, capital structure decision and dividend policy decision. Importantly, most of the prior studies have been conducted in developed countries and these studies have provided descriptive analysis (see: appendix A). In addition, these studies have not investigated the relationship between financial practices and firm's performance.

Financial practices are commonly followed in developed countries as compared to those in developing countries. In financial practices, capital structure decisions are very critical for the growth of a firm (Al-Mutairi, 2011). Therefore, managers always try to find out an optimal capital structure (debt/equity ratio) but it is very difficult to develop optimal capital structure due to its complex nature. However, there is still need to identify the optimal or near to optimal capital structure (Kumar, Anjum & Nayyar, 2012). Financing and investment decisions are significant in financial sector but these decisions are not evaluated properly (McConnel & Servaes, 1990). In the evaluation of financing and investment decisions, investment appraisal techniques are useful. These techniques have various concerns since management objective and constraints are very critical in appraisal process. In addition, investors are not conscious about the significance of appraisal techniques in firm's performance (Morgan & Tang, 1992) and they have no idea how to utilize these techniques properly (Akinbuli, 2011). Firms should find out a coordination between net cash flow or operations of firm (short-term assets and liability management) to reduce the threat of potential problems (liquidity, bankruptcy, short-term fluctuations etc.). According to Bei & Wijewardana (2012), demographics changes of firm and market systematic factors (e.g. demand, supply etc.) have impact on working capital policy. Moreover, different working capital policies are differently affecting the firm's performance due to the structure of firm and market conditions. Working capital policy can increase the firm performance but Palani & Mohideen (2012) documented that only few studies have been conceded to inspect this relationship by using primary data analysis. Thus, more research is needed to highlight the important of working capital in firm growth.

Methods of measuring cost of capital are major standards that help in the assessment of different financial sources. It also assists in accepting and rejecting an investment proposal, since it estimates the financing cost, which a firm must have to pay. However, which method is significant in forecasting the accurate cost of capital is still a puzzling issue for management (Kumar, Anjum & Nayyar, 2012). As, most of the firms rely on their experience and capital assets pricing model (CAPM) to evaluate the cost of capital because there is a lack of awareness on new methods like internal rate of return, weighted average cost of capital and project dependent cost of capital (Hunjra *et al.,* 2012).

There are some factors prevailing in the surrounding environment of the firm, which have great impact on financial decisions of a firm (Antoniou *et al.,* 2008). Agency cost is one of these factors, which have great impact on financial decisions especially decisions related to capital structure and dividend policy (Smith & Warner, 1979; Jensen & Meckling, 1976; Myers, 1977). Agency cost is borne by shareholder to encourage the management to work in the favorer of their wealth maximization. Agency costs are crucial for firm and shareholders, because shareholders bear losses if management works for its own incentive and remunerations, or may invest in non-profitable projects instead of maximizing the shareholder wealth. On the other hand, debt-holders must bear losses if management considers the value maximization of shareholder and abandon the debt-holder. Therefore, it is very significant to find out a way to settle the agency problems. In this context, most of the prior studies (e.g. Berger & Di-Patti, 2006; Brockman & Unlu, 2009; Caelers, 2010; Khan *et al.*, 2012) documented the relevancy of agency costs in capital structure decision and dividend policy but regarding the relationship between agency costs and capital structure, previous studies are comparatively inadequate (Tsuji, 2011). Similarly, the agency costs of debt and free cash flow have been widely discussed (Gonenc, 2005), but the affects of free cash flow (FCF) cost on firm's performance have not been examined (Al-Taleb, 2012). Therefore, this study is used agency cost as a moderator to highlight the impact of agency cost on the firm performace.

In Pakistan, Karachi Stock Exchange (KSE) is the largest and the oldest stock exchange, which is measured through KSE-100 index. KSE has made many achievements and remained among the top exchanges round the globe in terms of performance, though has declined over the last few years (IMF Country Report, 2013). KSE delisted more than 110 companies in the last four years and the common reason was that these companies were not paying dividends regularly. Moreon, some of the delisted companies faced bankruptcy due to lack of efficient financial policies. As, studies on Pakistani corporate sector state that most of the private and public firms do not follow financial practices due to lack of awareness regarding financial practices (Niazi *et al.,* 2011). Moreover, Pakistani firms do not properly employ any working capital policy and there is a need to explore the role of working capital policy in firm's performance (Hussain, Farooq & Khan, 2012). Agency cost is an essential issue in the business environment, which has strong impact on financial practices especially capital structure decision and dividend policy decision as well as on performance of the firm (Antoniou *et al.,* 2008). A study by Hunjra *et al.* (2012) on Pakistani corporate sector also indicates that financial practices are not being practiced properly in firms. Importantly, there is less understanding concerning application of these practices and their role in firm performance.

1.6 Research Questions

Descriptive and empirical investigations (e.g. see McCaffery *et al.,* 1997; Graham & Harvey, 2001; Benetti *et al.,* 2007; Rajatanavin & Venkatesh, 2007; Chazi *et al.,* 2010; Al-Mutairi & Hasan; Hunjra *et al.,* 2011) show that proper utilization of financial practices leads to growth and stability of a firm. Financial practices are very significant for the success (performance) of the firm (e.g. see Al-Mutairi & Hasan; Hunjra *et al.,* 2011). Therefore, the purpose of this study is to investigate the application of financial practices and its impact on firm performance as well as moderating role of agency cost. Specifically, to examine the following issues:

1. What are the financial practices currently being practiced among firms in Pakistan?

2. What is the empirical relationship between financial practices and firm performance?

3. Does agency cost moderate the relationship between capital structure decisions and firm performance?

4. Does agency cost moderate the relationship between dividend policy decisions and firm performance?

1.7 Research Objectives

Zikmund (1997; p37) explained the objectives of research as Researcher's version of business problem is the objective of research and it explains the purpose of research in measurable terms as well as defines the standard of what the research should accomplish. Identifying the application of financial practices and their impact on firm performance as well as interactive role of agency cost and its relationship with performance is the central objective of this study. Other objectives of this study are follows:

1. To explore the financial practices which are currently being practiced among firms in Pakistan.

2. To investigate the effect of financial practices on firm performance.

3. To examine the moderating impact of agency cost on the relationship between capital structure decisions and firm performance.

4. To inspect the moderating impact of agency cost on the relationship between dividend policy decisions and firm performance.

1.8 Significance of the Study

This study attempts to measure the application of financial practices in Pakistani corporate sector. These financial practices include capital structure decision, dividend policy decision, investment appraisal techniques, working capital policy, methods of measuring cost of capital and financial assessment using financial ratios. The proposed research investigates the effect of financial practices on firm performance as well as investigates the moderating effect of agency cost on the relationship of capital structure decisions and dividend policy decisions with firm performance. This study is significant from theoretical and practical perspectives; from a theoretical perspective, it brings reflective insights related to corporate finance theories (theories of capital structure decision and dividend policy decision) and agency problem theory particularly in context of an emerging market, i.e. Pakistan. Emerging markets are different from developed markets and factors that affect performance in emerging markets could be different from the ones that affect firm performance in developed markets. Therefore, this study provides a useful investigation whether theories of capital structure decision, dividend policy decision and agency cost that have been followed in developed markets are applicable in emerging markets (e.g. Pakistani markets). From a practical perspective, there is a lesson from findings of the research that guides to improve the managerial practices and financial decisions as well as their contributions to corporate performance. The finding of this study from listed companies on Karachi Stock Exchange (KSE) could provide a useful template for future research in other emerging and developing markets.

Most of the prior survey studies (i.e. McCaffery *et al.,* 1997; Graham & Harvey, 2001; Brounen *et al.,* 2004; Benetti *et al.,* 2007; Cohen & Yagil, 2007; Rajatanavin & Venkatesh, 2007; Chazi *et al.,* 2010; Al-Mutairi & Hasan, 2011; Hunjra *et al.,* 2011) have not employed comprehensive set of financial practices. The study of McCaffery *et al.* (1997) covers five practices: capital structure decision, dividend policy decision, investment appraisal techniques, working capital policy and financial assessment using financial ratios. The study by Graham & Harvey (2001) examined investment appraisal techniques, cost of capital and capital structure decision. Brounen *et al.* (2004) presented an international survey on investment appraisal techniques, methods of measuring cost of capital and capital structure decision. Benetti *et al.* (2007) investigated the application of cost of capital, investment appraisal techniques and capital structure decision. Al-Mutairi & Hasan (2011) examined investment appraisal techniques, methods of measuring cost of capital, capital structure decision and dividend policy decision. Notably, existing studies have not investigated the relationship between these practices and firm performance. Therefore, focus of this study is broad, which employs all the financial practices like capital structure decisions, dividend policy decisions, investment appraisal techniques, working capital policy, methods of measuring cost of capital, and financial assessments using financial ratios with moderating role of agency cost. This study used inferential statistics in data analysis as the proposed research investigates the relationship between financial practices and firm performance. Hence, this study provides better understanding of financial practices and their impact on firm performance.

In financial practices, the concept of cost of capital is crucial since there are various misconceptions present about this concept (Kester *et al.,* 1999). A number of studies (e.g. Bacidore *et al.,* 1997; Firer *et al.,* 2004; Vázquez & Trombetta, 2007; Rehman & Zaman, 2011) documented the importance of cost of capital in minimizing the risk of extra financing source cost. However, how a firm chooses a method to determine the reasonable amount of cost of capital and which method is better, is still a riddle (Kumar, Anjum & Nayyar, 2012). As Hujra *et al.* (2012) claimed that their work is pioneer in financial practices in Pakistan and they paid no attention on the importance of methods of measuring cost of capital. Therefore, this study intends to explore the methods, which are currently being pursued in calculating the cost of capital, and preference of the management regarding selection of method. Moreover, this study aspires to inspect the role and significance of methods of measuring cost of capital in firm performance. This study provides the better understanding to management on methods of measuring cost of capital and helps them in selection of methods.

A number of previous studies (e.g. Berger and Di-Patti, 2006; Brockman & Unlu, 2009; Caelers, 2010; Khan *et al.,* 2012) have explained the effective role of agency cost in decision-making of capital structure decision and dividend policy decision. Several studies (e.g. McKnight, 2008; Zhang, 2009; Byrd, 2010; Utami & Inanga, 2011; Al-Taleb, 2012) documented that agency cost (AC) negatively affects the capital structure decision and dividend policy decision. However, there is a need to identify the interactive role of AC and regarding the impact of AC on capital structure decision and dividend policy decision empirical studies are relatively insufficient (Tsuji, 2011). There are several kinds of AC, one of them is agency cost of free cash flow, which is also very important. The AC of debt and free cash flow have been widely discussed but effects of FCF cost on firm’s performance have not been investigated (Al-Taleb, 2012). Agency costs also exist in the developing countries like Pakistan at big level but studies who examined the agency cost are fewer in number (Gul *et al.,* 2012). In addition, in Pakistani profitable corporation, free cash flow is under the control of managers and they do not utilize the cash for the development of firm (Khan *et al.,* 2012). Therefore, this study aims to examine the moderating role of agency cost and its impact on the relationship of capital structure decisions and dividend policy decisions with firm's performance. This study helps the management in selecting dividend policy and capital structure to minimize the agency cost.

The literature review points out the existing gap in understanding the issues of financial practices, moderating role of agency cost and their impact on firm's performance. In addition, the emerging markets evidence is limited, for example, Hujra *et al.* (2012) claim that their research on financial practices especially investment appraisal techniques is a pioneer study in the context of Pakistan. They documented that financial practices are important for the growth of firm. On the other hand, Gul *et al.* (2012) documented that their study is pioneer work in the context of Pakistan, which addresses the agency problems. Therefore, this research adds to body of knowledge of financial practices through providing an opportunity to contribute to overall performance of corporate sector. Moreover, this study gives voices to potential companies' managers by providing them an opportunity to contribute to overall performance of the firm in terms of agency costs related decisions. This study provides evidence on the importance of the relationship between financial practices and firm's performance. From a theoretical significant perspective, this study fills a gap in understanding the perceptions of different stakeholders groups of firms related to agency costs issues.

This study explores the significant role of various techniques and methods that are used in financial practices and firm performance. In addition, this study also investigates the impact of AC on the relationship of capital structure decision and dividend policy decision with performance of a firm. Therefore, this study helps the financial analysts in selection and implementation of particular techniques, which significantly contribute in the performance of the firm as well as help in minimizing the agency cost. Moreover, it is hard for a firm to borrow money from financial institutions (e.g. banks, loan companies etc.) since the performance of the firm does not match the criteria of their policies. Therefore, this study provides an insight into firm and explores various financial techniques, which will enhance the performance and firm can easily borrow money from financial institutions. In government firms, financial practices are not followed properly since they are not aware of the importance of these practices in firm's performance. This study discloses the vital role of financial practices in firm performance and provides the evidence on the significance of financial practices.

1.9 Scope of the Study

This research is a survey study on application of financial practices in corporate sector and its impact on performance of a firm in the current economic conditions of Pakistan. This study can be generalized to the other economies keeping in sight their own country specific factors of corporate sector. Particularly, this study investigates, which financial practices are being carried out and at what extent in Pakistani corporate sector. In this study, primary data is used in measuring the financial practices, agency cost and firm performance. This study chooses financial and non-financial firms, which are listed in Karachi Stock Exchange (KSE). More than 650 financial and non-financial firms are listed on KSE and out them 350 firms are selected (based on the dividend policy of firms) by this study. These firms follow financial practices, since, not all firms follow financial practices properly. Most of the prior studies on financial practices are conducted in developed countries and these studies provide only descriptive findings of financial practices. This study investigates the application of financial practices and their impact on firm performance in developing market. In addition, this study examines the moderating role of agency cost on the relationship of capital structure and dividend policy with firm performance.

1.10 Operational Definitions

Followings are the operational definitions of variables considered for this research.

1.10.1 Financial Practices

Financial practices involve any decision made by managers that have any financial implication on operation of the business." (Al-Mutairi, 2011; p1)

1. 10.1.1 Capital Structure Decisions

The capital structure is how a firm finances its overall operations and growth by using different sources of funds. Debt comes in the form of bond issues or long-term notes payable, while equity is classified as common stock, preferred stock or retained earnings (Pratheepkanth, 2011; p2).

1. 10.1.2 Dividend Policy Decisions

A dividend policy is a company's approach to distributing profits back to its owners or stockholders. If a company is in a growth mode, it may decide that it will not pay dividends, but rather re-invest its profits (retained earnings) in the business (Amidu, 2007; p104).

1. 10.1.3 Investment Appraisal Techniques

Investment appraisal is the planning process used to determine whether an firm's long term investments such as, new machinery, replacement machinery, new plants, new products, and research development projects are worth the funding of cash through the firm's capitalization structure (debt, equity or retained earnings). It is the process of allocating resources for major capital, investment and expenditures (Chrysafis, 2012; p1042).

1.10.1.4 Working Capital Policy

It is a measure of both a company's efficiency and its short-term financial health. The working capital ratio (Current Assets/Current Liabilities) indicates whether a company has enough short term assets to cover its short term debt (Appuhami, 2008; p9).

1. 10.1.5 Methods of Measuring Cost of Capital

Cost of capital refers to the opportunity cost of making a specific investment. It is the rate of return that could have been earned by putting the same money into a different investment with equal risk. Thus, thecost of capital is the rate of return required to persuade the investor to make a given investment (Nel, 2011; p5337).

1.10.1.6 Financial Assessment using Financial Ratios

It is a process of evaluating businesses, projects, budgets and other finance-related entities to determine their suitability for investment. Typically, financial analysis is used to analyze whether an entity is stable, solvent, liquid, or profitable enough to be invested in (Wen, 2010; p3).

1.10.2 Agency Cost

It is a type of internal cost that arises from, or must be paid to, an agent acting on behalf of a principal. Agency costs arise because of core problems such as conflicts of interest between shareholders and management (Cohen & Yagil, 2006; p179).

1.10.3 Firm Performance

A subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. It is a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation (Graham & Harvey, 2001; p21).

1.11 Organization of Thesis

Aspire of this particular study is to examine the application of financial practices in Pakistani corporate sector and its effect on performance of firm as well as the moderating role of agency cost. The proposed thesis is projected into five chapters, which demonstrates and adds towards research streams of financial practices, firm’s performance and agency cost add to different analysis tools. Moreover, all chapters of this thesis are prepared and intimately allied on each other. In addition, all characteristics, which have argued in each chapter, are essential parts for the erection and implementation of a theoretical gallows on how efficiently financial practices can utilize for the betterment of the firm’s performance.

In this study, first chapter ‘Introduction’ presents the financial practices and their impact on firm performance as well as the moderating role of agency cost. The chapter has the background of the study, which includes the importance of finance in decision making of financial practices and importance of these practices in firm’s performance. Moreover, acknowledgement of problem statement, questions of research, objectives of research, significance of the study, scope of this research and operational definitions of variables are included in this chapter.

Chapter two of this study provides a review of the prior studies on the application of financial practices and importance of agency cost. Chapter 2 covers necessary theoretical background and empirical support for the thesis. Afterward in this chapter, concluding remarks and outcome of this literature review of earlier survey studies is covered.

In this particular thesis, research methodology outlines, research framework, research model and hypotheses of this study are presented in chapter three for the anticipated interconnectivity of the financial practices and firm performance along with interactive role of agency cost. This chapter also discloses the types of research, data collection methods, data sampling, data analysis techniques, mathematical model, verbal model and statistical tools that are used for inspecting the relationship between financial practices and performance of firm as well as the moderating effect of agency cost.

In this proposed study, all the results of data collection, analyses and results in detail are displayed in chapter four. Results are associated with the hypotheses established in chapter three. Moreover, all results of the relationship between financial practices and performance of firm along with moderating effect of agency cost are wrapped up in chapter five.

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